

Effective Date: December 17, 1998

**COORDINATED ISSUE
CONSTRUCTION/REAL ESTATE INDUSTRY
RETAINAGE PAYABLE
UIL 460.03-10**

ISSUE

Whether under section 460 a taxpayer may defer deducting retainages payable, until paid, in the numerator of its percentage of completion computation?

FACTS

A tax alert has been circulated that reads as follows:

"POSSIBLE OVERREPORTING OF CONTRACT INCOME
ACTION MAY BE APPROPRIATE DURING CURRENT TAX RETURN
PREPARATION

WHO MIGHT BE AFFECTED

taxpayers will be those:

- * required to use the percentage of completion method for Federal income tax purposes, and
- * whose contracts with subcontractors and others call for them to withhold retainages.

Many companies with long term contracts are required, for Federal income tax purposes, to report the income from them on the percentage of completion method. The tax law defines the percentage of completion as the percentage derived by comparing the costs incurred to date with the total costs estimated to be incurred on the project.

Under a 1969 Tax Court decision a contractor has not yet incurred the amount of a retainage its contract calls for it to withhold from a subcontractor. Accordingly, amounts retained from subcontractor should not be included in the calculation of costs incurred to date for purposes of determining a contract's percentage of completion. Many contractors may have missed this fine point. This Alert discusses it in more detail.

REFERENCES

§460 of the Internal Revenue Code
IRS Notice 89-15

Shepherd Construction Co., 51 TC 890 (March 1969)

ACTION REQUIRED

- * For contracts completed during the year for which a return is now being prepared exclude, retained amounts in calculating percentage of completion on the Form 8697 filed for this year.
- * For contracts in process at the end of the year for which a return is now being prepared, exclude retained amounts in calculating percent complete for purposes of determining taxable income.
- * For contracts completed in years still open consider filing amended Forms 8697 to claim interest the IRS owes the contractor.
- * For contracts in progress at the end of the year for which a return is now being prepared and for future years, determine year-end percentage of completion excluding subcontractors retainages.

Consider using the potential for having overreported taxable income as an entree to prospective clients.

Example: Here is how the contractor's \$100,000 in contract income will be reported in the two years of the contract, depending on whether contractor remembers to exclude subcontractors' retainages in determining percent complete:

Income to be reported on PCM

	<u>Year 1</u>		<u>Year 2</u>	
	Not <u>Excluding</u>	<u>Excluding</u>	Not <u>Excluding</u>	<u>Excluding</u>
Total contract price	\$1,200,000	\$1,200,000	\$1,200,000	\$1,200,000
Contract costs to date	\$ 800,000	\$ 720,000	\$1,100,000	\$1,100,000
Total est. contract costs	\$1,100,000	\$1,100,000	\$1,100,000	\$1,100,000
<u>Percentage of completion</u>	<u>0.7273</u>	<u>0.6545</u>	<u>1.0000</u>	<u>1.0000</u>
Income to be reported	\$ 872,727	\$ 785,455	\$1,200,000	\$1,200,000
less costs incurred	\$ 800,000	\$ 720,000	\$1,100,000	\$1,100,000
less prior inc. reported			\$ 72,727	\$ 65,455
Taxable contract income	\$ 72,727	\$ 65,455	\$ 27,273	\$ 34,545
	=====	=====	=====	=====

In this example, contractor has overstated income in year one. The total

income contractor reports on the contract \$100,000 is the same. So the only consequence is the year in which the contract income is reported. But this difference can generate interest payable from the IRS to the contractor."

LAW AND DISCUSSION

In the Construction Industry Coordinated Issue Paper Percentage of Completion Timing of Cost Recognition, effective 3/21/97, we held that Contractors cannot postpone the recognition of costs they incur for the work of their subcontractors in order to postpone income under the percentage of completion formula of section 460.

Section 460 requires most large long-term contracts to be accounted for under the percentage of completion method (PCM). The PCM requires income from the contract to be reported over the life of the contract and requires contract expenses to be deducted in the year that they are incurred.

Under the PCM, the first year's contract income is computed by multiplying the contract price by the ratio of first year contract costs to estimated total contract costs. A similar formula is used in future years, taking into account the amounts of costs and income that have already been recognized in prior years.

Because the recognition of income under the PCM formula is based on the amount of costs incurred to date, deferring costs will also delay the recognition of income. Given this potential benefit, contractors (such as the contractor described above) have been attempting to postpone the time that certain costs are deemed incurred under the economic performance rules.

Generally speaking, most taxpayers wish to take deductions as soon as possible (the reverse of the situation presented here). The Code protects against abuse in this regard by providing that an accrual basis taxpayer cannot treat the amount of any liability as incurred until the all events test is met. See, e.g., section 461(h)(4). The all events test is met with respect to an item if all events have occurred which determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy.¹ Id. See also United States v. General Dynamics Corp., 481 U.S. 239 (1987); United States v. Hughes Properties, Inc., 476 U.S. 593 (1986).

Section 461(h)(1) added "economic performance." as the third prong of the all-events test. As modified by § 461(h)(1), the all-events test for an item is not treated as satisfied

¹The amount of the liability to the subcontractor may not be determinable with reasonable accuracy until the amount is billed by the subcontractor.

any earlier than the taxable year in which economic performance occurs.

Section 461(h)(2) provides the time when economic performance is deemed to occur for various types of liabilities. With respect to liabilities for services and property provided to the taxpayer, section 461(h)(2)(B) provides that economic performance occurs as the taxpayer receives the services or property. See also Treas. Reg. § 1.461-4(d)(2)(ii).

As discussed above, contractors have been advised to defer deduction of the retainage payable portion of their costs by arguing that the retainage is not a deductible cost until payment is made (cash method).

There are many flaws in this argument.

First, the contractor billed the owner for various items, preformed by its subcontractor, including construction services and raw materials. Economic performance with respect to construction services occurs as the construction services are rendered.

Second, the contractor is working only for the owner and the owner has accepted the work there by triggering economic performance. Under the accrual rules of section 461, payment is not required for these cost to be deductible.

Third, IRC section 461(h)(2)(B) and Treas. Reg. § 1.461-4(d)(2)(ii) provide that, with respect to long-term contract expenses, economic performance occurs as the services or property is provided or, if earlier, as the taxpayer makes payment.

Fourth, there is no evidence to show that any of the work under any of the contracts in question herein had to be redone. Furthermore, we may not indulge in a presumption that the contractor did not do the work under the contracts according to specifications or that any of it had to be redone.

Unauthorized Change in Method of Accounting

Contractors have been asserting that Treas. Reg. § 1.461-4(m)(2) authorizes them to change their accounting method for subcontractor expenses. That section states in part:

For the first taxable year beginning after December 31, 1991, a contractor is granted the consent of the Commissioner to change its method of accounting for long-term contract liabilities described in paragraph (d)(2)(ii) of this section and payment liabilities described in paragraph (g) of this section...to comply with the provisions of this section.

Treas. Reg. § 1.461-4(m)(2) provides, in relevant part, automatic consent for changes in method of accounting for long-term contracts to comply with the economic rules under Treas. Reg. § 1.461-4. As discussed in detail above, the method changes are not being made to comply with section 461(h).

In Shepherd Construction Co. v. Commissioner, 51 T.C. 890 (1969), the Tax Court determined that a highway contractor improperly deducted a portion of subcontractors' expense retained by the contractor. In reaching its conclusion the court relied on the fact that "[a]t the time of the partial payments to its subcontractors, all events had not occurred which rendered petitioner's obligation to pay some amount of the retainage to them fixed and certain. [citations omitted]". Shepherd Construction, 51 T.C. at 898. The court also determined that the change in the petitioner's treatment of retainage was properly characterized as a change in method of accounting:

Our decision requires a determination of the proper time, under petitioner's accrual method of accounting, for the deduction of a business expense which is concededly ordinary and necessary. Both parties agree that this determination ultimately depends upon a proper application of the "all events" test established in United States v. Anderson [1 USTC ¶ 155], 269 U. S. 422 (1926), and incorporated into section 1.461-1(a)(2), Income Tax Regs.

* * * *

Section 446(b) gives respondent the broad discretion to compute taxable income under a method of accounting which, in his opinion, clearly reflects income. See Lucas v. American Code Co., 280 U.S. 445 (1930). We cannot say that respondent has abused his discretion when, on this record, we discern no significant differences in the terms of payment under the prime contracts and the subcontracts sufficient to justify petitioner's inconsistent treatment of retainages provided for under the two types of contracts. **The consequence of the exclusion from income on the one hand and the inclusion of an expense on the other was a distortion of petitioner's annual profits.** See and compare Wright Contracting Co., 36 T. C. 620 (1961), affd. 316 F. 2d 249 (C.A. 5, 1963), certiorari denied 375 U. S. 879; Ohmer Register Co. v. Commissioner, 131 F. 2d 682 (C. A. 6, 1942). "Emphasis added"

As can be seen, in the Shepherd case, the taxpayer excluded retainage receivables from income, but deducted retainages payable. The court held that for an accrual basis taxpayer the exclusion from income on the one hand and the inclusion of an expense on the other was a distortion of petitioner's annual profits.

Notice 89-15 Q&A-32: Provides that under the percentage of completion method, costs that are allocable to a contract are allowable as deductions from gross income in computing taxable income in the year in which they are incurred.

Notice 89-15 Q&A-33: Provides that regardless of the taxpayer's overall method of accounting, contract costs generally are treated as incurred in the taxable year in which the "all events" test of section 461 and Treas. Reg. § 1.461-1(a)(2) of the regulations, as modified by section 461(h), is met. Section 461(h) was added by the 1984 Tax Reform Act.

On these facts, economic performance has occurred and full payment is not a requirement for deduction. Accordingly, under section 460, a taxpayer may not defer deducting retainages payable, until paid, in the numerator of its percentage of completion computation. Retainages payable are deductible when the all events test is met and economic performance has occurred; for long-term contract expenses, economic performance occurs as services or property is provided, or, If earlier, as the taxpayer makes payment. Treas. Reg. §1.461-4(d)(2)(ii).

Change in Method of Accounting Issues

A change from including retained amounts in the cost incurred for determining a contract's percentage of completion to excluding retained amounts for that purpose, or vice versa, is a change in method of accounting subject to section 446. Section 446(e) and Treas. Reg. § 1.446-1(e)(3) require a taxpayer to obtain the Commissioners consent before changing its method of accounting, regardless of whether the present or proposed method is proper or is permitted under the Code or regulations.

The automatic consent provided in Treas. Reg. 1.461-4(m)(2) for the first taxable year beginning after December 31, 1991, does not provide consent to a taxpayer to begin excluding previously included retained amounts from the cost incurred for determining contract's percentage of completion. This is because a method that excludes retained amounts from the cost incurred for determining a contract's percentage of completion does not comply with the provisions of Treas. Reg. § 1.461-4. If the taxpayer made such a change in method of accounting without the consent of the Commissioner, the taxpayer made an unauthorized change in method of accounting.

If the examiner is examining the taxpayer's tax return for the year of an unauthorized method change (i.e., taxpayer changes to excluding retained amounts from the cost incurred for determining a contract's percentage of completion), the examiner should reject the taxpayer's unauthorized change in method of accounting. Taxable income for the year should be recomputed on the method used by the taxpayer for the preceding year (i.e. retainage amounts included in the cost incurred for determining a contract's

percentage of completion. The RAR should clearly state that the taxpayer made a change in method of accounting without having obtained the consent of the Commissioner, contrary to the requirement of section 446(e) and Treas. Reg. § 1.446-1(e), and that the reversal of the taxpayer's unauthorized change in method of accounting is being proposed. The RAR should also state that the method of excluding retained amount from the cost incurred for determining a contract's percentage of completion is an improper method of accounting since it is inconsistent with Treas. Reg. §1.461-4.

If the examiner is examining the taxpayer's tax return for a year subsequent to the year of such an unauthorized method change, or a year subsequent to the year the taxpayer adopted its current erroneous method of excluding retained amount from the costs incurred for determining a contract's percentage of completion, and the taxpayer is not eligible to change its method of accounting under Rev. Proc. 97-27, 1997-1 C.B. 689, the examiner should change the taxpayer's erroneous method of accounting to the proper method under the authority of section 446(b) and the related regulations. The RAR should state both the proper new method of accounting and that a change in method of accounting, subject to sections 446 and 481, is required. The RAR should also label the section 481(a) adjustment. The change in method of accounting will ordinarily be made in the earliest year under examination and the entire amount of the positive section 481(a) adjustment should be included in the examiner's computation of the taxpayer's taxable income for the year of the method change.

If a taxpayer attempts to change from including retained amounts in the costs incurred for determining a contract's percentage of completion to excluding retained amounts for that purpose in an amended return (claim for refund) without having obtained the consent of the Commissioner, the taxpayer's claim for refund should be disallowed. The primary reason for disallowance is the lack of consent under section 446(e) and Treas. Reg. § 1.446-1(e)(3). See also, Rev. Proc. 97-27, 1997-1 C.B. 689. § 2.04. The secondary reason for disallowance is that the method of excluding retained amounts from the costs incurred for determining a contract's percentage of completion is inconsistent with the requirements of Treas. Reg. § 1.461-4.

CONCLUSION

IRC Section 461(h)(2) and Treas. Reg. § 1.461-4(d)(2)(ii) provide that, with respect to long-term contract expenses incurred after 1991, economic performance occurs as the services or property is provided or, if earlier, as the taxpayer makes payment.

If a taxpayer changed from including retained amounts in cost incurred for determining a contract's percentage of completion to excluding retained amounts for that purpose, the taxpayer has changed its method of accounting for purposes of IRC § 446 and the

regulations thereunder. Absent application of the automatic consent provision of Treas. Reg. § 1.461-(4)(m)(2)(i), a taxpayer may not change its method of accounting for federal income tax purposes without first obtaining the Commissioner's consent. Treas. Reg. § 1.461-(4)(m)(2)(i) does not apply to a change to exclude previously included retained amounts from the cost incurred for determining a contract's percentage of completion. Therefore, if a taxpayer changed its method of accounting without the advance consent of the Commissioner, the taxpayer made an unauthorized change in method of accounting.